THE SPIN-OFF OF CHEUNG KONG INFRASTRUCTURE

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ABSTRACT

In recent years, spin-off is a common phenomenon in the Hong Kong stock market. Listed conglomerates such as Cheung Kong (Holdings) Limited and New World Development Company Limited have applied listing for their infrastructure businesses, mainly in the PRC, separately. The combination of infrastructure businesses, which is lacking in Hong Kong, and the PRC-based concept has made the newly listing vehicle very appealing to the investors and fund managers. The encouraging results have induced other listed companies to consider spin-off part of their business. We are quite interested in analysing this phenomenon and want to find out the reasons and also advantages for spin-off. . Apart from that, areas of interest including basis of pricing, cash flows implication, response of IPO, subsequent share price performance etc.

Cheung Kong Infrastructure Holdings Limited (CKI), the spun-off subsidiary of Cheung Kong (Holdings) (CKH) will be the primary targeted company under our analysis. Apart from fund raising and the other managerial incentives, our study finds out that spin-off can also solve the information asymmetry from the view of stakeholders. Thus, the share price performance of CKH was directly improved as a consequence. However, the CKI's initial public offering (IPO) price (HK$12.65) was too demanding to induce public interests, therefore the share price of CKI was disappointing on debut when compared with the other newly red chips listed in the same period.

On the flip side of a coin, spin-off also has its own negative impacts on both spun-off unit and the parent; thus management must strive a balance before undergoing the spin-off process.

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PREFACE

On July 17 1996, Cheung Kong (Holdings) Limited has spun-off its infrastructure-related businesses into a newly created listed company, Cheung Kong Infrastructure Holdings Limited (CKI). The combination of China concept and infrastructure businesses has made CKI stock very appealing to the investors. Approximately one year after the initial listing, CKI has became a new constituent stock of the Hang Seng Index. Its market capitalisation has increased from HK$17.9 billion to the historical high of HK$63.5 billion on August 6, 1997 and now ranked 13th largest listed company in Hong Kong. Mr Victor Li Tzar-kuoi, the elder son of tycoon Mr Li Ka-shing, has turned out to be the youngest CEO among the 33 constituent stocks.

We would like to thank Professor H Zhang for providing some valuable advice and guidance to us on how to properly complete the project.

CHAPTER I

INTRODUCTION

Before the Hong Kong stock market turned lethargic amid of the recent Asian currency turmoil, an incessant steam of spin-offs have been announced or proposed by different locally listed companies. The word 'spin-off' refers to the corporate activity whereby a company lists out another special purpose vehicle by injecting a selected class of assets into it.

Several research works have done to prove that spin-off is positive to both parents and spin-offs. A significant positive share price reaction is documented for 93 voluntary spin-off announcements between 1963 and 1981. These shareholder gains do not appear to come wholly at the expense of bondholders. Evidence suggests the gains to shareholders may arise from tax and regulatory advantages and/or improved managerial efficiency resulting from the spin-off (Schipper & Smith, 1983). In the other article, significantly positive abnormal returns for spin-offs were observed when the parents and the spin-offs were in combinations. Both the spin-offs and parents experience an unusually high incidence of takeovers and the abnormal performance is limited to firms involved in takeover activity. These findings suggest that spin-offs provide a low-cost method of transferring control of corporate assets to bidders who will create greater value (Cusatis, Miles & Woolridge, 1993). Besides, spin-offs generate significant increases in real asset growth and cash flow margin on sales for combined firm measures (spun-off firm plus parent firm). The gain result from increases in real asset growth for parent and spun-off firms, and improvements in cash flow margin on sales for parents. Spin-offs create value by improving investment incentives and economic performance (Johnson, Klein & Thibodeaux, 1996).

However, another finding suggests that spin-off is not a panacea because evidences showed that positive gains for firms engaging in spin-offs to facilitate mergers or to separate diverse operating units but negative returns to firms responding to legal and/or regulatory difficulties. No evidence is found to indicate the gains to stockholders represent wealth transfers from senior security holders (Hite & Owers, 1983).

Recently, a study proposes a managerial discretion hypothesis of equity carve-outs in which managers' values controls over assets and undertakes carve-outs only when the firm is capital constrained. Consistent with this hypothesis, firms that carve out subsidiaries exhibit poor operating performance and high leverage prior to carve-outs. Wherein funds raised are used to pay down debt, the average excess stock return is significantly greater than carve-outs wherein funds are retained for investment purposes (Allen & McConnell, 1998). Although the topic of spin-off has been studied in the western countries for years, papers focusing on Asian companies are scarce. That is the main reason we choose this topic for our final year projects.

Our Approach

Instead of adopting an approach of glimpsing a glut of spin-off cases to draw a general conclusion, our group prefers to choose a very classical case for detailed study. Consequently, our report will be full of profundity and analytical precision without doubt. **The spin-off of Cheung Kong Infrastructure Holdings Limited (CKI)** is chosen to serve our need whereby two major questions will be examined in this project.

1. What were the managerial purposes or incentives for this spin-off?
2. During the Initial Public Offering (IPO), whether the conditions and terms of financing like timing, offering size and pricing of CKI were appropriately pre-determined or not.

As a matter of facts, these two simple questions could help us to evaluate whether this is a commendable deal or not.

CHAPTER II

METHODOLOGY

Steps

1. Before performing different kind of analyses, we will first describe the whole spin-off story of CKI. In particular, both the pre- or post-spin-off structure (financial as well as organisational structure) will be fully covered at the outset.

2. What were the managerial purposes or incentive of the spin-off of CKI ? In fact, we intend to sort out the supporting reasons to carry out this corporate deal.

    a) Firstly, we have reason to believe that Cheung Kong (Holdings) Limited (CKH) has a imminent financing need in FY1996. Our surmise is based on the fact that CKH placed out 100 million new shares, or 4.55 per cent of its existing issued share capital to institutional investors at HK$53.0 per share on February 6, 1996. This was the first share issue of CKH since the large scale rights issue announced on the eve of 1987 October stock market crash. Is our surmise right or wrong? Or whether CKH's financing needs had already been sufficiently served by the HK$5.3 billion gross proceeds from the aforementioned private share placement. We will find out the answers.

    b) Before the spin-off of CKI, investors traditionally classified CKH as property developer with a very unclear theme of diversification. In fact, the contribution of property sales was merely accounted for 43 per cent of earning in FY1995 (the financial year before the spin-off of CKI) and the rest were generated from sources like profit of Hutchison Whampoa Limited (HWL), building materials and property rental. The problem of information asymmetry occurred when institutional investors or financial analysts tried to assess the fundamental value of CKH because the financial disclosure of its non-property related business was insufficient. This intractable agency problem has depressed the relative value of CKH for a long time, compared with those of other peers like

Sun Hung Kai Properties Limited (SHK Properties), New World Development Company Limited (New World) and Henderson Land Development Company Limited (Henderson Land). Market base indicators like Price to Earning (P/E) ratio and Discount to Net Asset Value (NAV) will be used to demonstrate this unfavourable trend to CKH. Meanwhile, our group will also use these indicators to examine whether this problem of information asymmetry was partially relieved after the spin-off of CKI.

3. From the historical kaleidoscope of well-executed corporate activities, CKH has clearly demonstrated an inimitable savvy in packaging the erstwhile deals. Is same kind of appreciation deserved for the spin-off of CKI ? We will examine this question by looking at the timing, offering size as well as the pricing of CKI. To be more precise, we will evaluate the 'timing' of this spin-off by retrospectively looking at the market perception of PRC infrastructure stocks in the first half of 1996. In addition, the IPOs of other PRC infrastructure companies like New World Infrastructure Limited (NWI) and Road King Infrastructure Limited (RKI) will also be considered inasmuch as their listing date were close to that of CKI. According to the basic law of demand, there is an inverse relationship between the quantity demanded and the price of any goods. The same rule should also be applicable to stocks of CKI. We are going to look at whether the management of CKI had successfully achieved a balance between the offering size and the pricing of IPO. The IPO price will be compared with the other PRC infrastructure stocks, in terms of prospective P/E, discount to Net Present Value (NPV) and discount to NAV on the eve of the announcement date of CKI's spin-off.

Up to this point, we must reiterate that we have no intention to critize the spin-off of CKI. In fact, this is an unfair game because the management of CKH and our group have separately made the own judgement based on two different information sets. CKH's information set probably consisted of some unknown private information whereas our set contains some post-spin-off information for certain. On the other hand, although both parties aiming at value-maximisation, the management of CKH probably made its decisions with other minor objectives like boosting up the short-term profitability or/and reducing the gearing ratio, etc. which may not be considered by us. Consequently, some of their decisions may be absurd on the surface. In fact, we would like to learn a lesson by reviewing and analysing the whole process of spin-off of CKI.

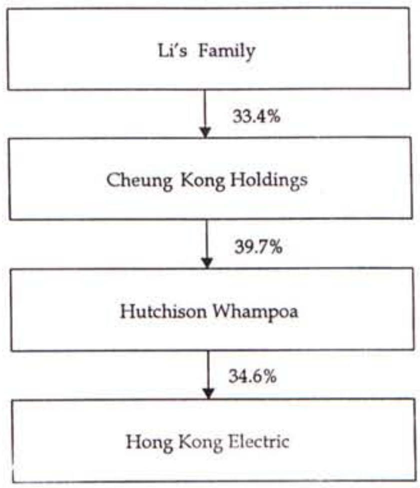
CHAPTER III

MAJOR BUSINESSES OF CHEUNG KONG (HOLDINGS) LIMITED PRIOR TO THE SPIN-OFF

General Description

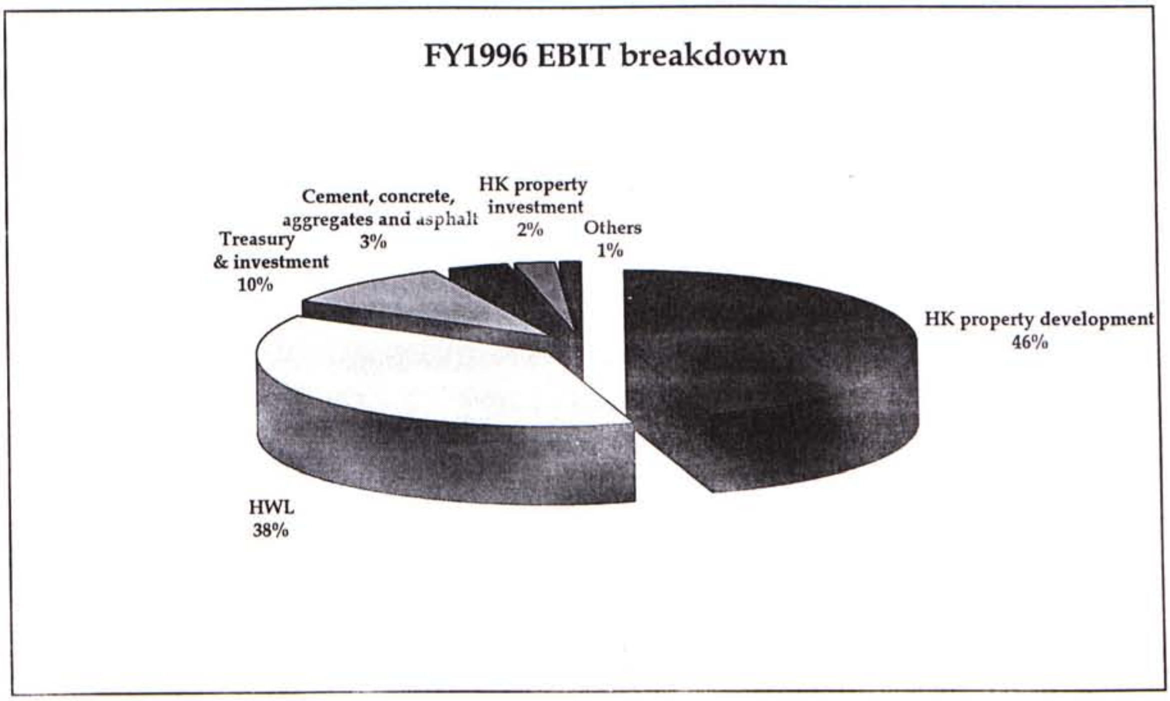
CKH was incorporated in 1971 and listed in 1972. The founder, Chairman and the Managing Director of the company, Mr. Li Ka-shing has been active in the property business in Hong Kong since 1958. Having property development as its main business, CKH is one of the leading developers in the mass residential property market. Apart from that, CKH also had interests in property investment, non-property investments, infrastructure and cement & quarry operations. Its primary associate, Hutchison Whampoa Limited (HWL), is the largest conglomerate in Hong Kong which held Hong Kong Electric Holdings Limited (HKE), the sole provider of electricity to Hong Kong Island and Lamma Island. The Cheung Kong Group structure before the spin off of CKI is shown as follows:

Cheung Kong Group Structure
prior to CKI's spin-off in 1996

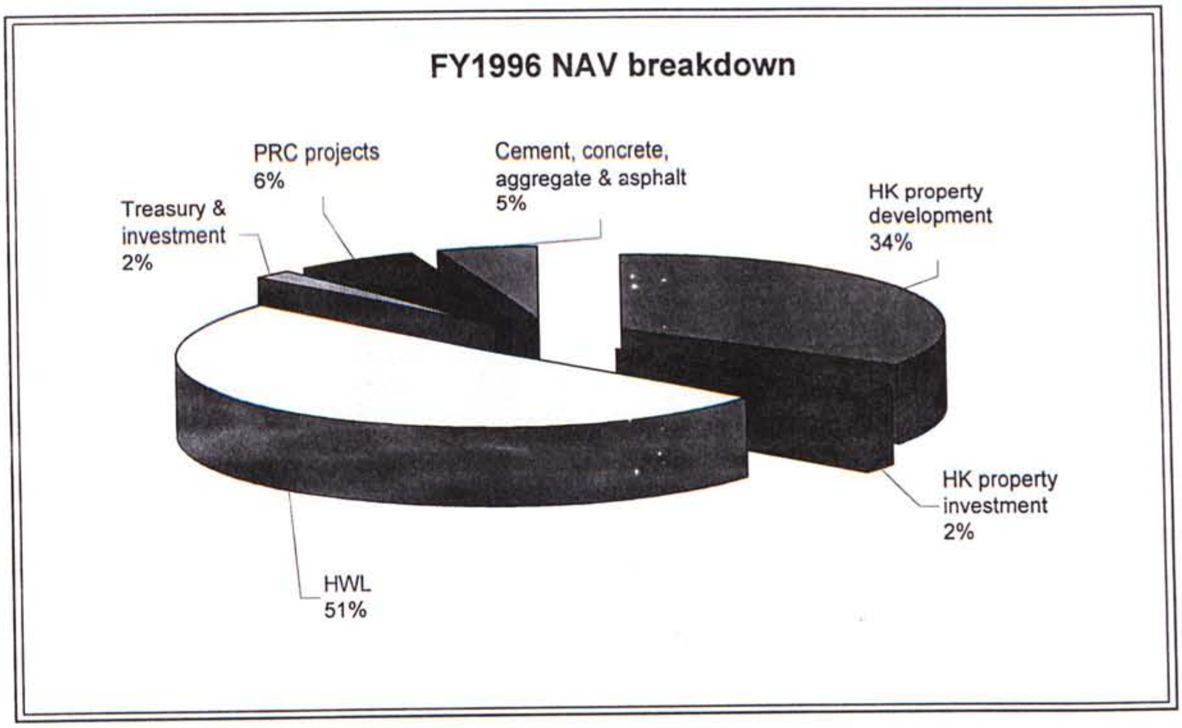


The distribution of CKH's Earnings Before Interest and Tax (EBIT) by line of businesses for the past three fiscal years are summarised as follows:

%	FY1994	FY1995	FY1996	Average
HK property development	50	43	46	46
HK property investment	1	1	2	1
Cement, concrete, aggregate & asphalt	2	5	3	3
PRC projects	0	0	0	0
Treasury & investment	12	14	10	12
HWL	33	37	38	36
Others	2	0	1	2



The distribution of the NAV of CKH by major line of businesses in 1996 is illustrated below:



Major Lines of Business

1. Property development in Hong Kong

Although the management was actively seeking to reduce the over-dependence on the property development business especially on the residential property side, the significance of property sales was on average accounted for nearly 50 per cent of CKH's operating profit. Hence, the Company was traditionally classified as a property developer in spite of its diversified operations.

In the first half of 1996, CKH was the third largest developer in term of landbank size and it had the highest portion of residential sites among the major developers, which accounted for 80 per cent of its total developable landbank. CKH had a long history of concentrating mainly on large-scale developments of small to medium sized residential flats (i.e. less that 1,000 sq. ft).

%	SHK Properties	Henderson Land	**CKH**	New World
Residential	70	64	80	59
Office	8	13	15	14
Retail	1	13	0	4
Industrial	21	10	5	23
Other	0	0	0	0
Total GFA (m sq. ft)	**26.5**	**13.3**	**12.1**	**6.1**

Sources: FY1996 Annual reports

CKH was different from the other property developers in that it always had a high-proportion of joint-venture projects because of its lack of Letter B land exchange entitlements. Normally, its joint-venture partners were attracted by its experience in building large-scale projects and its proven record of being able to negotiate low land premiums with the government. Perhaps the most remarkable achievement was the speed at which CKH had been able to sell the badly-located Kingswood Villas during the last residential property doldrums (1994-95). It used several innovative marketing devices to promote sales, including the now-routine additional mortgage subsidies to help those first-time buyers, holding carnival parades, offering helicopter rides and hiring a team of real estate agents to contact potential buyers. All of these practices were still very unusual among the large property developers at that time.

Looking into the FY1996 annual report, CKH had prepared the following property projects for sales. There were three main contributors: 2,860 units of Kingswood Villas; University Height, a joint venture development with HSBC Holdings and two best-located blocks of Laguna City which consisted of about 420 units.

Properties for sale in FY1996				
Property	Stake (%)	Usage	Attributable GFA (sq. ft)	Unit sales price estimates (HK$ m)[1]
Kingwood Villas	**98.5**	**R**	**1,919,218**	**2,650**
Laguna City	**50.0**	**R**	**313,525**	**5,500**
University Heights	**50.0**	**R**	**157,158**	**5,100**
Concordia Plaza	20.1	O	258,827	7,050
New Treasure Centre	100.0	I	200,035	1,895
Shing Yip Centre	100.0	I	24,000	2,100
Total			2,872,764	

Residential = R, Office = O, Industrial = I

Sources: CKH annual report, Hong Kong Economic Times

[1] Based on the selling price of the secondary market

2. Property investment in Hong Kong

CKH owns a relatively small investment property portfolio. Within the group, HWL is the major investor and holds the Group's major rental properties, while CKH had adopted a strategy of 'developed and the sold'. CKH has disposed of the retail space that was developed as part of the company's major residential projects, such as Laguna City and South Horizons, though other developers tend to retain such space. Starting in 1996, there has been a change in CKH's strategy, perhaps prompted by objective to diversify the income sources. The retail podium at Bayshore Towers (located in Ma On Shan) had been leased instead of being an outright disposal.

3. China Properties

Similar to other developers, CKH has accumulated a landbank in China of an attributable 8m sq. ft of developable floor space. The sites were evenly distributed in Beijing (29 per cent), Guangdong (27 per cent), Shanghai (19 per cent) and other areas (25 per cent), and were primarily for residential or commercial developments. None of the projects had pre-sold record up to FY1996. The major problem of the China property market was the supply glut in all sectors, which was created by the earlier investment frenzy in an unregulated environment in 1992. The major cities had already seen rentals and prices falling from their peak levels in 1995. Reacting to the poor state of the China property market, CKH had immediately slowed down its project construction even the Compan_ had already invested about HK$4 billion in China properties up to FY1995.

Potentially, CKH's most lucrative projects in China was the construction of Oriental Plaza, which located next to Beijing's Tiananmen Square. Nonetheless, the construction had been pending for approval until second half of 1997. In a view to speeding up the process, a stake was already sold to a government-related entity.[2]

In July 1994, CKH issued US$350m floating rate notes which could be exchanged into shares of Cheung Kong Holdings (China) Limited on its planned IPO before February 11, 1998.[3]

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[2] As background information, Oriental Plaza had been one of the most controversial projects in recent Chinese history. The proposed development had encountered three setbacks. There were complications regarding the closure of a McDonald's restaurant that still had a 20 year lease to run at that time. The project was then turned down as the development exceeds the area's height limit.

4. Government subsidised housing (GSH)

Not much mentioned by the investment community, CKH had five PRC government-subsidised housing projects. In 1996, New World was the only other Hong Kong developer that had exposure to this type of development. After encountering so many problems in exploiting the PRC residential property market, investors gradually recognised that GSH was in fact, the best exposure to this market. Through margins were extremely low, the GSH programme had the guarantee of returns from provincial governments and the large project size ensured a stable source of future income. In addition, demand was from locals and did not rely on foreigners whose demand was comparatively difficult to estimate. Predicted by the management, these projects should able to make profit contribution after FY1999.

Government-subsidised housing programme			
Projects	City	Type	GFA (sq. ft)
Changyang Village	Beijing	R	4,897,620
Majiabao Western	Beijing	R	2,260,440
Daxue Road	Shantou	R	11,302,200
Jiulong Lake	Chongqing	R	11,302,200
Yanghe Reservoir	Chongqing	R	1,356,250

5. Hutchison Whampoa Limited (HWL): the most valuable assets

HWL was one of the Hong Kong's leading conglomerates with interests in property development and investment, container terminals (HIT), retailing, telecommunications, energy and financial servicing, etc. In 1996, HWL had lifted its strategic stake in HIT to nearly 78 per cent. And it was becoming more active in port related infrastructure development in China. In addition, HWL also spun-off the personal communication system (PCS) arm, Orange in United Kingdom in April 1995, wherein HWL derived a windfall gain of approximately HK$4 billion. However, as HWL is not a major party in the whole spin-off of CKI, it will not be our core part of discussion.

6. Cement, concrete, aggregates and asphalt

The cement and concrete businesses, through Green Island Cement (Holdings) Limited (GIC) and Anderson Asia (Holdings) Limited (AA), had enjoyed a 80 per cent growth in operating profit to HK$458m in FY1995. Due to CKH's monopolistic position in these businesses and lack of

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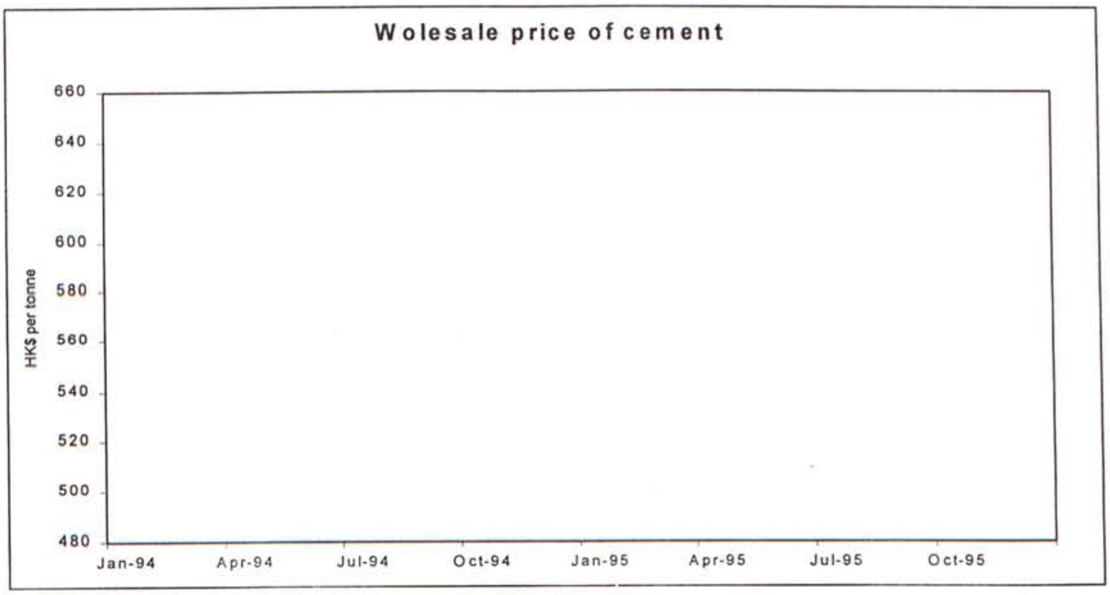
[3] At the time of writing, the notes were matured without floatation of Cheung Kong Holdings (China) Limited.

penetration of imports, prices of its products – cement, concrete, aggregates and asphalt – have gone up significantly in line with increased demand. This, plus internal cost-cutting, has led to a tremendous increase in margins.



GIC was established in 1886, is the oldest cement producer in Asia and is the only cement manufacturer in the Hong Kong market. GIC had a 47 per cent share of the market in 1995, and 37 per cent of sales went to AA for concrete production. Fifty-five per cent of third-party sales went to Pioneer Concrete under a long-term supply contract, which was expected to be renewed for another five years upon expiry in 1998. Average local consumption was about 4m tpa in 1995, 50 per cent of which was satisfied by imports from China and Japan. The risk of dumping by the major suppliers was unlikely to materialise, given regional demand for cement for infrastructure developments. Contrary to the common belief that the cement industry is cyclical, cement demand had averaged 3.8m tpa over the period from 1990 to 1995, staying within the range of 3.3-4.2 m tpa.

China was GIC's new target market. It only supplied foreign-funded projects in China, which were willing to pay higher prices for better quality and reliability. PRC sales accounted for 8 per cent in 1995. GIC planned to increase its presence in China by sub-contracting cement production to local companies under the 'Golden Eagle' brandname, thereby creating a branded product that could be sold at lower prices, especially as such sales were not subject to import duties

CKH acquired AA from HWL in 1989. AA derived income from three main sources: concrete (83 per cent); asphalt (15 per cent); and quarrying (2 per cent). Like GIC, AA had a leading position in the Hong Kong concrete market, with a 23 per cent market share in 1995.

AA operated its own granite quarry at Lam Tei – there were only five quarries in Hong Kong- and had two franchised aggregates suppliers in Shwnzhen and Zhuhai. Output from the top five companies, including AA, K Wah and Shui On, accounted for nearly 80 per cent of the ready-mixed concrete market. The need for a waterfront site for the import of raw materials has prevented competitors from entering the market. More importantly, concrete does not travel well, and operators need to have several batching sites. In 1995, AA operates at eight batching locations locally and also had stakes in two batching plants in Guangzhou and one in Zhuhai. AA was the only manufacturer in Hong Kong capable of producing 100 Mpa concrete.

7. The PRC infrastructure development

CKH's PRC infrastructure investments included toll bridges/highway and power plants in Guangdong Province, particularly in Shantou city. In the first half of 1996, CKH had secured toll road/bridge projects and six power plant projects.

Shenzhen-Shantou Highway, Eastern Section

This is the eastern section of the 268 km expressway linking the two major coastal cities, Shenzhen and Shantou (the home town of Mr. Li Ka-shing). In June 1993, a 75:25 joint venture between CKH and HWL entered into an agreement to take a 30 per cent stake in the project, which involved a total investment of HK$2 billion.

Zhuhai Power Plant

The first phase of the project, involving an investment of US$1.18 billion, consisted of two set of 700MW coal-fire generators. A joint-venture majority owned by CKH and HWL held a 45 per cent stake in the project while the Guangdong Electricity Group and the Zhuhai Special Economic Zone Power Development Corporation owned the remaining 55 per cent. Under the master plan, the total capacity of the Zhuhai power plant would be 3,720 MW and total investment would reach US$3 billion. Upon completion in 1999, the power plant will serve as the power-house of Zhuhai. Progress of the project had been slowed down in 1994-1995, awaiting the arrangement of project financing.

Shantou & Nanhai Power Plants

In Nanhai, CKH had invested in two power plans. The 15 per cent owned Nanhai Power Plant Phase 1 consisted of a diesel/heavy oil generator with an installed capacity of 400 MW and was expected to commence operation in late 1996. The other plant, owned 18.2 per cent by CKH, was the Nanhai Jiangnan Power Station with installed capacity of 121 MW. The plant was operational. CKH also held a 22.5 per cent interest in three existing oil-fired power plants in Shantou with a total installed capacity of 279 MW.

CKH Power station projects

City	Name	Group interest (%)	Installed capacity (MW)	Type of power plants	Estimated year of completion
Shantou	Shantou Tuopu Power Plant	60	114	Diesel Oil/Heavy Oil	Existing
Shantou	Shantou Chenghai Power Plant	60	75	Diesel Oil/Heavy Oil	Existing
Shantou	Shantou Chaoyang Power Plant	60	90	Diesel Oil/Heavy Oil	Existing
Nanhai	Nanhai Power Plant I	30	400	Coal/Heavy Oil	1996
Nanhai	Nanhai Jiangnam Power Station	36	121	Oil	Existing
Zhuhai	Zhuhai Power Plant I	45	1,400	Coal	1999

Source: CKH annual report

CKH Highway and bridge projects

Name and location	Group interest (%)	Approximate length (km)	Estimated year of completion
Shenzhen Shantou Highway, Eastern Section	22.5	140.2	1996
Shantou Bay Bridge	22.5	2.5	1996

Source: CKH annual report

8. Treasury investment

CKH invested in listed shares in two forms: long-term and short-term investments. Through arguably the former was more 'fixed' in nature, while the latter was by definition for trading purposes, in reality CKH had been selling down its long-term portfolio. At the end of 1995, 48 per cent of the listed securities investment were held as current assets in terms of costs. Long-term investments in equities and convertible bonds began in 1991, when CKH invested substantial amount in listed property and related companies, and companies with China exposure. The core holdings in CKH's convertible portfolio were Shougang Concord International's and Guangzhou Investment's HK$587 million and HK$234 million issue, to expire in December 1998 and October 1998 respectively. Major Hong Kong-listed investments included a 12.4 per cent stake in Shougang Concord International, 5 per cent stake in Hopewell, 3.1 per cent stake in CEPA and 6.8 per cent stake in China Resources Enterprises. Some analysts argued that this diversification had bought about future business opportunities.

CHAPTER IV

ANALYSIS OF FINANCIAL POSITION OF CKH

On February 6, 1996, CKH had turned to the market for cash, raising HK$5.3 billion in the second-largest placement in the SEHK's history[4]. It was placing 100 million shares with Li Ka-Shing Trustee Co Ltd at HK$53.00 per share for the purpose of providing additional general working capital to the Group. CKH was taking the opportunity to cash in as the market had gone up so much and CKH shares had gained almost 16 per cent so far this year. The placement price represented a discount of 4.1 per cent on February 6, 1996 closing price of HK$55.25. The shares was sold on a new-for–old basis, with the company selling 100 million existing shares – representing 4.5 per cent of capital – and creating an equal number of new ones. The placement followed a string of other cash calls by blue chips in a few months[5]. The proceeds were expected to be channelled into a string of property projects it was either involved in or bidding for.

It is not surprising CKH is raising funds at that moment. It had an exceptionally expensive year in 1995 when exploiting lower prices to accumulate new land. With more major sites up for grabs in coming future, its bills look set to balloon further. Highlights include when CKH:

- Announced in January 1995 the go-ahead for the redevelopment of the Hok Un power station in Hunghom in a joint venture with China Light & Power Co. The redevelopment would consist of 25 residential towers, a five-storey commercial building and parking space.
- Paid HK$565 million in August 1995 to buy Television Broadcasts' studio in Broadcast Drive,

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[4] The placement is the biggest since Citic Pacific raised more than HK$7 billion in January 1993.

[5] Henderson Land raised HK$2.2 billion in December 1995 and Sun Hung Kai Properties and Citic Pacific raised HK$4.03 billion and HK$3.24 million, respectively, in January 1996.

Kowloon Tong. It was estimated the site could be converted to 152,640 sq. ft of living space.

- Bought a 164,689 sq. ft residential site in Tai Po at a government land auction in September 1995 for HK$280 million.
- Formed a consortium with Citic Pacific to win the HK$8 billion tender for rights to build 2.64 million sq. ft of housing above the Mass Transit Railway Corp's (MTRC) new airport railway station on Tsing Yi Island.
- Teamed with HWL in December 1995 to win rights to build a 1.4 million sq. ft commercial complex on the Hunghom Bay reclamation with the Kowloon-Canton Railway Corp. The HK$6 billion development would include a 600-room hotel and three office towers.
- Formed a consortium in December 1995 to bid for rights to develop an HK$8 billion residential site above the MTRC's planned station on the West Kowloon reclamation, large enough to provide 1.59 million sq. ft of housing space.
- Led a consortium in January 1996 to bid for rights to carry out the proposed HK$40 billion commercial development above the MTRC's planned station on the Central reclamation.
- Revised plans given the go-ahead by Beijing's planning commission to complete its controversial US$1.2 billion Oriental Plaza commercial development in Beijing near Tiananmen Square and the Forbidden City.
- Joined HWL to win a tender on 5th February 1996 with a HK$2.7 billion bid to secure a 277,980 sq. ft residential site at Ma On Shan.
- Appeared likely to bid for a HK$2 billion 172,224 sq. ft commercial-residential site at Hung Hom Bay reclamation next month.

Other Financial Obligations

Apart from bank borrowings, CKH also had the following significant financial obligations:

In 1993, Cheung Kong Finance Cayman Limited (CKFCL), a wholly owned subsidiary, issued US$500 million guaranteed bonds in bearer form which carry interest at the fixed rate of 5.5% per annum. Since the date of issue, US$242,450,000 of the said bonds had been redeemed and US$257,550,000 remained outstanding at 31st December 1996. These bonds, which are guaranteed by the Company and listed on the Luxembourg Stock Exchange, will mature in September 1998.

In 1994, CKFCL issued another US$500 million guaranteed step-up floating rate notes in bearer form which carry interest at the rate of 0.6% above the 3 months LIBOR. These notes, which are guaranteed by the Company and listed on the Luxembourg Stock Exchange, will mature in January 2001 or, at the options of the noteholders giving not less than 60 days' notice, become redeemable in January of each year from 1997 to 2000.

In 1994, Cheung Kong Finance China Limited (CKFCL), a wholly owned subsidiary, issued US$350 million exchangeable guaranteed floating rate notes in bearer form which carry interest at the rate of 0.5% above the 3 months LIBOR. The notes are exchangeable into shares of Cheung Kong Holdings (China) Limited (CKHCL), another wholly owned subsidiary, only after an initial public offering by CKHCL of its shares on a stock exchange. Since the date of issue, US$39,500,000 of the said notes has been purchased back by another wholly owned subsidiary. These notes, which are guaranteed by the Company and listed on the Luxembourg Stock Exchange, will mature in August 1999; or at the options of the noteholders giving not less than 60 days' notice, become redeemable in August 1997 or; at the options of the noteholders giving not less than 30 days' notice, become redeemable on the first anniversary date of the listing of CKHCL.

With the potential early redemption, at the option of the noteholders, of the U$500 million guaranteed step-up floating rates notes issued by CKFCL and the US$310.5 million outstanding exchangeable guaranteed floating rates notes issued by CKFCL, the total cash commitment in 1997 amounted to approximately HK$6.3 billion. With the remaining US$258 million guaranteed bonds issued by CKFCL matured in September 1998, an extra HK$2 billion is required. Together with the huge capital requirements for the property development project in HK and the PRC infrastructure business, CKH should have a significant cash burden.

The following is an extract of the CKH capital commitment from the 1996 annual report, which can illustrate the huge capital requirement of the PRC infrastructure projects.

Capital Commitments as at 31st December

(HK$ millions)	1996	1995
Contracted for		
Fixed assets	102	48
PRC projects	2,336	449
Others	59	-
	2,497	497
Authorised but not contracted for		
Fixed assets	248	124
Others	31	80
	279	204
Total	2,776	701

CHAPTER V

FUNDING STRATEGIES

Alternative financing methods available to solve the tight cash flow requirements of CKH which included:

- **Syndicated loan facility**. Given the financial creditability of Cheung Kong Group, it would not have any problem. However, interest cost would be higher than before owing to the rise in gearing ratio.
- **Convertible bond**. Although the interest rate was relatively cheaper, the potential premium payable on non-conversion and the dilution effect upon conversion made the instrument unattractive. There would be also some financial covenants to maintain such as debt to equity ratio and debt service coverage.
- **Refinancing of existing bank loan**. Sufficient cash and credit would not be immediately available to cover existing capital commitments as well as projects under negotiation for the next few years.
- **Long-term commercial paper**. It was not a commonly used financing method in Hong Kong.
- **Floating rates notes**. CKH would need to bear interest rate risk.
- New **equity issue/rights issue**: It had the disadvantage of diluting the interest of Li's family interest in CKH and put pressure on current share price.

- **Spin-off[6] of infrastructure-related businesses.**

Environment in both the IPO market and the stock market in general are critical. The favorable equity markets had provided significant funds for many infrastructure companies in the first half of 1996. CKH was the latest in a series of Hong Kong companies to spin-off infrastructure and related businesses. These actions could unlock the earnings potential of their businesses. CKH's spun-off unit also benefited from its parent's size and reputation, as well as its own diversified sources of earnings.

Based on the 1996 consolidated cash flow statement of CKH, we can see that CKH cash balance would be negative in the absence of the two major corporate activities (ie private placement and spin-off of CKI) in 1996. If CKH borrowed debt, instead of issuing new shares and the spin-off of CKI, its gearing ratio would be increased sharply which made the future borrowing and refinancing activities more expensive.

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[6] Please refer to Appendix I for an analysis of spin-off.

CHAPTER VI

THE WHOLE STORY OF CKI'S SPIN-OFF

On **May 20, 1996,** CKH formally announced it had already applied to the Stock Exchange of Hong Kong (SEHK) to spin-off its PRC infrastructure business. Although CKH confirmed the widespread market talk about its spin-off, it did not elaborate the deal in great details. Besides, CKH also revealed that it had signed a letter of intent with the Nanhai City Government for the development of roads and power plants. The market naturally thought that these projects would be a part of the spin-off unit. At that time, some investors started to speculate that CKH would like to restructure the overlapping infrastructure business of the whole CKG by injecting both CKH's and HWL's infrastructure projects into the spin-off unit. Their rationale was that by inclusion of the port business of HWL would substantially increase the size as well as earning quality of the new company which would therefore become more attractive to foreign investors. Responding to this news of spin-off which might reap strong gain for both CKH and HWL, CKH and HWL shares finished 1.9 per cent and 1.7 per cent higher at HK$54.25 and HK$48.50 respectively.

On **May 24, 1996,** the South China Morning Post reported that HWL's managing director Mr. Canning Fok clarified that HWL's PRC port operations would not be included in the proposed listing company but HWL would sell its power and road projects to CKH to serve this purpose.

On **May 28, 1996,** Hong Kong Economic Journal reported that CKH made it clear that convertible bondholders of Cheung Kong Holdings (China) Limited were not allowed to convert their bonds into the new shares of its spun-off unit.

On **June 5, 1996,** Hong Kong Economic Journal reported that CKH had signed the letter of intent and paid RMB1.5 billion for eleven toll bridges in southern Guangdong province of China. The market believe that these roads would be injected into the new spun-off unit.

On **June 10, 1996**, CKH said the assets of its infrastructure unit was worth about HK$11.98 billion and it would be named as **Cheung Kong Infrastructure Holdings Limited (CKI)**. After the listing, CKI would still backed by CKH's management team and **Mr. Victor Li Tzar-kuoi** (the elder son of Mr. Li Ka-shing) as chairman while **Mr Kam Hing-lam** as managing director. CKH made it clear that CKI would include the following projects:

Roads	Power Plants	Building materials
Shantou Bay Bridge	Nanhai Plants	Green Island Cement
Shenshan Highway	Shantou Plants	Anderson Asia
Nanhai Roads	Zhuhai Plant	

Source: IPO prospectus of CKI

CKI was expected to earn at least HK$728 million in the FY1996, 27.9 per cent more than that of last financial year.

At a luncheon presentation on **June 11, 1996**, CKH announced details of the spin-off of CKI. CKI would sell 297.8 million new share, which represented 22.5 per cent of the company's enlarged issued share capital of HK$1.3 billion. 268.0 million or 90 per cent of new shares were offered to institutional investors in a global placement. The offering price range would be HK$11.00 to HK$12.65 each, which was equivalent to 20.3 to 23.4 times of CKI's forecast earnings per share in FY1996, and 5 per cent to 15 per cent below its net asset value per share. HSBC Investment Bank Asia and CEF Capital were appointed as joint co-ordinators for the global placement. Both parties had an over-allotment option (greenshoe) to offer an additional 44.2 million CKI shares after the listing. If this option was exercised, the total number of shares offered to the public would be 342 million which accounted for 25 per cent of CKI's total shares.

On **July 1, 1996**, CKH announced that the global placement of CKI secured a satisfactory result by capturing a 10 times oversubscriptions. After considering the strong response, CKH and the joint co-ordinators fixed the offering price at HK$12.65, which was at the top end of the offering price range. CKI would raise HK$3.8 billion through the sale. That amount would increase to HK$4.3 billion if the over-allotment option was exercised. Furthermore, CKH also announced that the IPO of CKI would begin on **July 7, 1996** and close on **July 11, 1996**.

On **July 12, 1996**, CKH said the IPO of CKI was 23.2 times oversubscribed. Because of the strong retail demand, CKI determined to 'clawback' 14.9 million shares that it sold earlier to institutions and sell them to the retail investors.

On **July 17, 1996**, CKI shares failed to sparkle on their debut amid the bad sentiment of the overall market. CKI shares reached a high of HK$12.90 on its first trading day but fell back to close at HK$12.75, a petty rise of 10 cents or 0.79 per cent from the HK$12.65 issue price. Meanwhile, the Hong Kong market had suffered mainly on Wall Street's losses amid concern on interest rate hike. Hang Seng Index posted a 18.88 points loss and closed at 10,609.10 after dropping 172.15 points on one day before. Investors were generally disappointed by the share price performance because the CKI shares in the grey market had once pitched at about HK$14.00 one week prior to its debut, quoted by South China Morning Post.

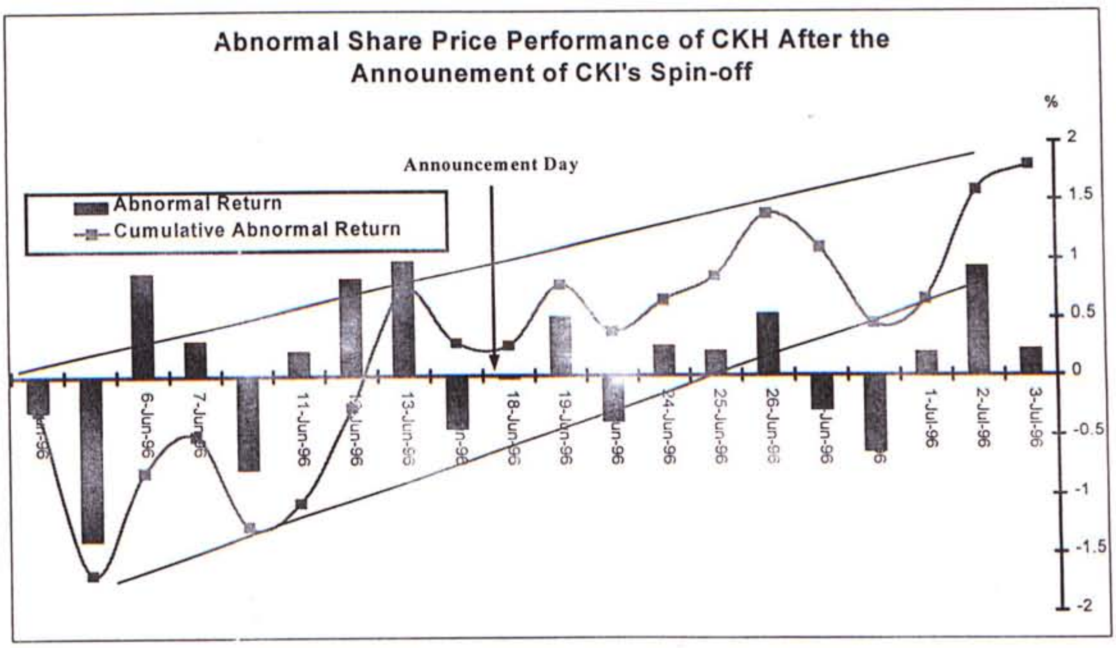
For details regarding the business profile, management team, major line of businesses etc of CKI, please refer to Appendix II. Please also refer to Appendix III for a more detailed Cheung Kong Group Structure Chart after the spin-off.

CHAPTER VII

MARKET COMMENTS ON CKI'S SPIN-OFF

In this section, our group summarises and analyses the market comments on the spin-off of CKI.

1. The deal was welcomed by the market



The market did hold the view that the CKH was the ultimate beneficiary of the CKI's spin-off by increasing the shareholders' wealth. To prove this point, our group plots the daily abnormal returns and the summation of daily abnormal returns (cumulative abnormal returns) of CKH starting from ten days prior to CKI's spin-off announcement day until ten days post that important announcement. The equation applied is R_{CKH} - $beta_{CKH} * R_{HSI}$, where

R_{CKH} = the daily return of CKH

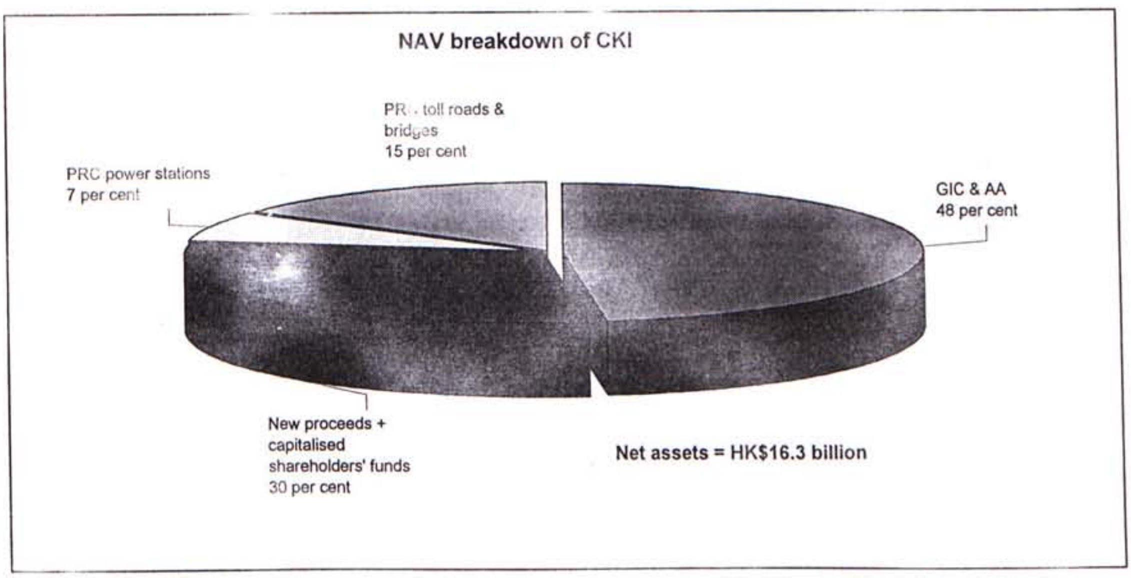
$beta_{CKH}$ = the beta of CKH under the Capital Asset Pricing Model (CAPM)[7]

R_{HSI} = the daily return of Hang Seng Index

Evidently, the spin-off of CKI was definitely a value-added deal for CKH. The stock price of CKH had set to accumulate a positive abnormal return ten days before the formal announcement of CKI's spin-off and this rising trend of cumulative abnormal return could also sustain for next ten days after the formal announcement. This implies that investors showed great enthusiasm to this spin-off and had been increasing their stakes in CKH in the meantime.

2. CKI was not a China play

Even though the successful listing of CKI was fully appreciated by the market, fund managers were having split opinions on this issue. First and foremost, the two Hong Kong based construction-material-makers, GIC and AA would have accounted for HK$2.3 billion, or 93.2 per cent, of CKI's total revenues and HK$458.2 million, or 80.5 per cent of its total earnings in 1995. On a net asset value base, these two makers also represented nearly 48 per cent of net asset value. By all means, investors were buying a Hong Kong infrastructure company with some PRC exposures indeed.



[7] The value of beta is 1.13.which was calculated by using Bloomberg terminal and the time horizon was January 1 1996 to June 1 1996.

Then why did CKH select this unbalanced portfolio for CKI. Our group surmises that CKH did not accumulate enough high quality assets to capture the sudden demand in this PRC infrastructure spin-off fever[8]. It was understandable because in one personal interview with Bloomberg News, Mr Li Ka-shing disclosed that CKH's PRC investment was not more than HK$10 million before 1992 and his personal influence was only limited in Shantou area where he borne. Besides, as we mentioned before, interests of the toll roads and power plants of CKI were just purchased in hurry from HWL for spin-off purpose. Furthermore, the Nanhai power plant and road network were purchased just approximately one month prior to the spin-off announcement of CKI. These projects were still in the infancy stage, the financing need was imminent whereas the profit contributions were far remote. As a result, GIC and AA must be injected into CKI to provide the company's recurrent income base for future expansions.

3. The whole deal was in hurry

Not only the injected assets were prepared in great hurry, but also CKH was suspected to spend only two months or even shorter for the deal diligence. What is our reasoning? On **April 26, 1996**, the Hong Kong Economic Times reported that CKI had planned to inject four Hebei toll roads into a listed company called CEF Concord Holding Ltd (CEFC) (the name of the company change to ITC Corporation Ltd. in February 27, 1997), which was a shell company and 36.1 per cent held by a consortium led by CKH. These four toll roads had already in operation and they were claimed to have a promising profit potential (These roads were later sold to CKI after its listing). Even the market rumour was denied by CKH, giving the details of the news descriptions, it could quite clear that CKH once prepare to list out its PRC infrastructure unit by means of a shell company. Our group believes that CKH had made a sea change in the original strategy for several reasons. Firstly, the listing of NWI showed that the market extremely favour and was willing to pay a higher price premium for an infrastructure company having a huge and diversified portfolio (comprising of PRC roads, power plants and some Hong Kong based recurrent income sources), hence the spin-off of CKI was a well-

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[8] In view of the recent fever of spin-off in Hong Kong, the SEHK has introduced a guidance note on 12th May 1997 and is summarised in Appendix IV.

matched strategy. Secondly, assets injection into a small company like CEFC required a very long process, it would take one or even two years to inject new PRC infrastructure projects in return for share placements to both CKH and institutional investors. (Like the case between Citic Pacific Limited and CITIC). By adopting a one-off listing of CKI, CKH was able to capture a sentiment climax by asking for a higher offering price.

4. The valuation of CKI was rich

The bearish market sentiment was blamed to be the culprit of CKI's disappointing performance on the first five trading days. Apart from that, we think CKI's IPO price (HK$12.65) was fundamentally demanding to induce public interests. Trading at about 23.4 times FY1996 prospective P/E meant that it was at par to NWI's FY1996 prospective P/E of 24.2 times[9] and also at a large premium to RKI's FY1996 prospective P/E of 19.0 times[10]. CKI was not cheap in any sense, so it did not provide a trading opportunity for short term investors. As a result, its share price was not exciting on its debut.

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[9] Based on closing price on July 17, 1996
[10] Based on closing price on July 17, 1996

CHAPTER VIII

THE MAIN REASON FOR CKI's SPIN-OFF

As the major shareholder who held 33.4 per cent of CKH, Mr Li. Ka-shing had an excellent track record of creating value for shareholders in making every strategic decisions concerning CKH. A brief history of major strategic decisions made by CKH is summarised in Appendix V. Our group believes the spin-off of CKI was not an exception.

1. The past track record

The substantial re-rating of CKH in 1995 was mainly triggered by HWL's spin-off of Orange, a UK mobile phone operator. The deal made CKH to be the highest-gaining property developer for the year, with a 57 per cent increase in share price, outperforming SHK Properties (47 per cent) and Henderson Land (31 per cent), also narrowing the gap between CKH and the two companies. However, having started from a rather low base, CKH was still trading at discounts to others in its peer group in first half of 1996. Our question is whether this discrepancy is justified or not. Supposed we simply followed the traditional wisdom by classifying CKH as a property developer and comparing its share price in term of P/Es with other peers. As can be seen from the table below, CKH was the least expensive, in terms of P/Es in that time.

	P/E (x)			
	1995A	1996A	1997E	1998E
CKH	13.1	12.6	11.4	9.7
Henderson Land	15	13.2	11.8	10.4
SHK Properties	20.3	19	16.7	14.7
New World	22	19	16.6	13.6

Source: Bloomberg

As Henderson Land is generally perceived as a pure developer, we have used its P/Es to represent the market ratings for property development profit. We have stripped out HWL and compared the rest of CKH's operation with Henderson Land's ratings. CKH was trading at more than

50 per cent discount to Henderson Land in term of P/E. As CKH's landbank was more concentrated on the high value-added residential sites, its quality was not inferior to that of its peer group. Was this deep discount unjustified?

	P/E (x)				NAV premium/(discount)%
	1995A	1996A	1997E	1998E	
CKH	7.3	8.1	6.9	5.7	(10)
Henderson Land	15	13.2	11.8	10.4	10
Discount to Henderson Land (%)	51	39	42	45	20

Source: Bloomberg

As we have extensively explained above, CKH had many facets indeed. It is categorised as a property developer, but its diversified operations offered the flavour of a conglomerate. Some had even valued CKH as a holding company. In addition, how about those **'hidden assets'** in the balance sheet. Similar to CKH, New World had been trading at a deep discount to other developers for some 'unknown reasons'. However, its ratings have substantially readjusted after the spin-off of NWI and the revaluation of the China property portfolio for the convertible bond issue.

Another reason that CKH had been trading at a discount is because it is being treated as a holding company on the basis that HWL contributes 50 per cent to CKH's NAV and nearly 40 per cent to earnings. Holding companies normally trade at discounts to other companies. For advocates of this view, the spin-off of CKI and likely listing of the China properties division in 1998 further entrench their beliefs. However, we do not believe that CKH has the characteristics of a typical holding company unless it spins off its Hong Kong property development operation, which seems a non-value-added scenario in the view of investors.

Even if we take their view as truth, we still can not justify the low valuation of CKH. By taking another blue chip companies, Wheelock & Company (WC) as an example: WC has derived some 80 per cent of its earnings from its listed subsidiaries and associates, including Wharf, New Asia Realty, Realty Development Corporation, Lane Crawford etc.., which also accounted for over 90 per cent of its NAV. Showed in the table, CKH even had a greater discount and lower P/E than WC. WHY?

	P/E (x)				NAV premium/(discount)%
	1995A	1996A	1997E	1998E	
CKH	13.1	12.6	11.4	9.7	(11.9)
WC	16.3	15.2	13.4	15.4	(8.3)

Source: Bloomberg

Then how about regarding CKH as a conglomerate. Although the Company has the diversified nature of a conglomerate, it was very dependence on the profit generating from property sales. Consequently, investors also asked for a discount when investing in CKH. This point can be demonstrated when comparing the valuation of CKH with that of other 'hongs' including HWL, it is bound that CKH was cheaper than a typical 'hong'.

	P/E (x)				NAV premium/(discount)%
	1995A	1996A	1997E	1998E	
CKH	13.1	12.6	11.4	9.7	(11.9)
HWL	22.5	18	17	15.5	(1)
Citic Pacific	25.3	11.7	19.7	16.6	31
Swire Pacific	16.9	15	13.9	12.5	(3)
First Pacific	10.5	15.2	12.9	11.5	(22)

Source: Bloomberg

2. Information asymmetry

Supposed CKH was cheapest according to any general classification methods, did it imply the market efficiency of the Hong Kong stock market was very low in 1996? We do not share this view for two reasons:

We do consider that there existed an information asymmetry problem between the shareholders and management of the whole Cheung Kong Group at that time. Firstly, there were too many overlapping in the business operations of the whole group before spin-off of CKI. For instance, both CKH and HWL had significant direct exposure in the PRC infrastructures projects. The overlapping was most serious in CKH because it nearly had some interests in any main businesses of the Group. This unclear business theme make the work of forecasting profit growth of CKH extremely difficult. Secondly, CKH held a very great portfolio of the PRC infrastructure projects like those bridges, expressways and power plants. As their short-term contributions were not significant, equity analysts sometimes even ignored them in calculation the future profits and NAV of CKH. In the other word, they were **'hidden assets'** in the balance sheet of CKH. May be even analysts would like to make a more comprehensive analysis on these PRC projects, they did not have sufficient information to do so. Without a clear disclosure on the terms and conditions of each project in particular, estimation on cashflows was very difficult if not impossible. For this reason, our group think that the spin-off of CKI was a value-added strategy for shareholders of CKH. In fact, CKH started to consistently outperformed the Hang Seng property index after the CKI's spin-off.

CHAPTER IX

OTHER MANAGERIAL PURPOSES AND INCENTIVES OF CKI'S SPIN-OFF

1. Generate extraordinary profit

The spin-offs went forward under the rubrics of restructuring and creation of shareholder value. In fact, the spin-off exercise generated an exceptional gain of HK$1.5 billion for CKH. Such gain arising from dilution of the CKH's interest through placing and new issue of shares in CKI pursuant to the spin-off of the CKH's interest in infrastructure and related business.

2. Capital raising

Generally speaking, the spun-off unit can raise more equity capital by going public as an alternative or complement to funding obtained from banks and other financial institutions. No interest is payable on equity raised, although shareholders will expect to receive dividends. It also reduces the huge capital commitment from parent. The net proceeds from the CKI share offer, after deducting related expenses, were estimated to amount HK$4,158 million since the over-allotment option is exercised in full. The Directors of CKI had proposed to utilise the net proceeds in the following ways:

- approximately HK$1,125 million would be used to meet the capital contribution requirements of the Group relating to the road and power businesses; and
- the remaining balance would be used for potential investments in the future and for general corporate purposes.

Besides, as a listed company, the spun-off unit can more easily obtain loans from financial institutions and at a more favorable interest rate because it is more "transparent". In other words, financial institutions have a better knowledge of the company by reference to its published accounts, announcements of new projects, etc., as reflected in the market price of its shares. On August 8, 1997, CKI assembled a group of banks to underwrite a HK$3.8 billion five years loan package to refinance debt and enhance working capital. The interest rates for CKI was 39 basis points more than the HIBOR rates and CKI was granted the option to choose whether the one-, two-, three-. Or six-, month HIBOR was used as the pricing benchmark. The term of financing was even more favorable than those offered to CKH indeed.

3. Business expansion

The spun-off unit can also pay for the acquisition of other businesses by issuing its own shares to shareholders of the target company, instead of paying cash or arranging for loan finance. For example, CKI had acquired the 35 per cent interest of HKE from HWL by issuing new shares in January 1997.

4. The company's value is easily determined

Once the initial value of the spun-off unit's shares is determined at the time of listing, the value will change on a daily basis according to its financial results, its future plans and prospects, the trading volume and other market factors. The availability of an indicative share price on a daily basis facilitates the trading and transferring of shares and can increase the shareholders base.

5. Status

The spun-off unit's status in the eyes of third parties is greatly enhanced by obtaining a public listing. This can assist it in negotiations with suppliers, customers and bankers, and thus lead to an improvement in its business operations generally. Furthermore, the more often the name of the spun-off unit appears in newspaper articles, the better it should be known by the investing public and its target customers.

6. Portfolio insurance

By spin-off CKI, CKH could also minimise the downside risks associated with a Chinese infrastructure developer, such as capital intensive requirement, delays in completion and the unreliability of return guarantees.

7. Indication of financial strength

As a company must meet some strict requirements before it is listed, its listing indicates that it has successfully fulfilled such criteria. Its reputation will be further enhanced if it can continually produce good financial results, which should lead to an increase in its share price. A run up in the price of the spun-off unit should positively impact the value of the parent, which remains majority control. This will also put it in a good position to raise further capital by means of rights issues or private placements.

8. Promotion of share options schemes

Part of staff remuneration can be provided by way of a share option scheme, which can also act as an incentive to increase profits and productivity. However, such a scheme is only viable if staff can easily assess the value of the company's shares and, eventually, sell their holdings for cash at any time. Going public can therefore enable the spun-off unit to employ, motivate and retain high calibre executive talents.

9. Improved financial position

The debt of the spin-off is removed from the parent company's balance sheet. This resulted in lower parent company debt and, possibly, reduced financial leverage.

Spun-off unit often pays special dividends to their parent as part of the spin-off transaction. Spun-off will also benefit from the reduced interest expense on debt forgiven by the parent because of loan capitalisation. For example, CKH had forgiven debt to CKI and such transactions alter the financial structure of the spun-off unit and its profitability going forward.

CHAPTER X

POSSIBLE DISADVANTAGES OF SPIN-OFF

1. Public scrutiny

The spun-off will become the focus of investors' and the media's attention after listing. Its activities will be monitored by the public and exposed to critical comment both in the press and elsewhere.

2. New responsibilities and pressures

The spun-off unit must observe all the Listing Rules and other requirements of the SEHK, such as the publication of its interim and annual reports, and issuing notices to shareholders and the public regarding significant acquisitions and disposals of assets, and deals with connected parties transactions. In addition, the public would expect the spin-off to distribute dividends periodically.

3. Time and expense

A considerable amount of executive time can be taken up in communicating with the SEHK and shareholders both during and after the spin-off process. However, investors can obtain a better understanding of the spun-off's business by examining its published financial and other information, which should in turn attract further investment. Additional administrative expenses will be borne by the spun-off unit as a public company.

4. Directors' remuneration and liabilities

The determination of directors' remuneration and retirement fund provisions is governed by stricter rules and monitored more carefully than with private companies. In addition, directors have to undertake to observe the SEHK's Model Code for Securities Transactions by Directors of Listed Companies, which sets out certain restrictions on dealing in shares of the company, for example when the directors have access to confidential information that will affect the price of the shares. Directors also have to comply fully with the provisions of the Securities (Disclosure of Interests) Ordinance and the Securities (Insider Dealing) Ordinance.

CHAPTER XI

THE SHARE PRICE PERFORMANCE OF CKI

CKI was listed at the selling price of HK$12.65 each, which was equivalent to 23.4 times its FY1996 forecast earnings per share and 5 per cent below its NAV per share. The Company issued 342.30 million shares and raised HK$4.3 billion in total. In term of the involved amount, this was the largest IPO in 1996 indeed. Although the IPO of CKI was 23.2 times oversubscribed, our group believed that the issuing price of CKI was set at a relatively expensive level. Therefore, its share price was not performed very well shortly after its debut. We think CKI's IPO price (HK$12.65) was fundamentally demanding to induce public interests. Trading at about 23.4 times FY1996 prospective P/E meant that it was at par to NWI's FY1996 prospective P/E of 24.2 times[11] and also at a large premium to Road King's FY1996 prospective P/E of 19.0 times[12]. CKI was not cheap in any sense, so it did not provide a trading opportunity for short term investors. As a result, its share price was not exciting on its debut.

Fortunately, its strong earning momentum became the key determinant to support CKI's stock performance in the long term. Why does our group draw this view? Our group will first evaluated the share price performance of CKI in both short-term and long-term. Subsequently, we will argue why the IPO price seemed to be too high at that moment.

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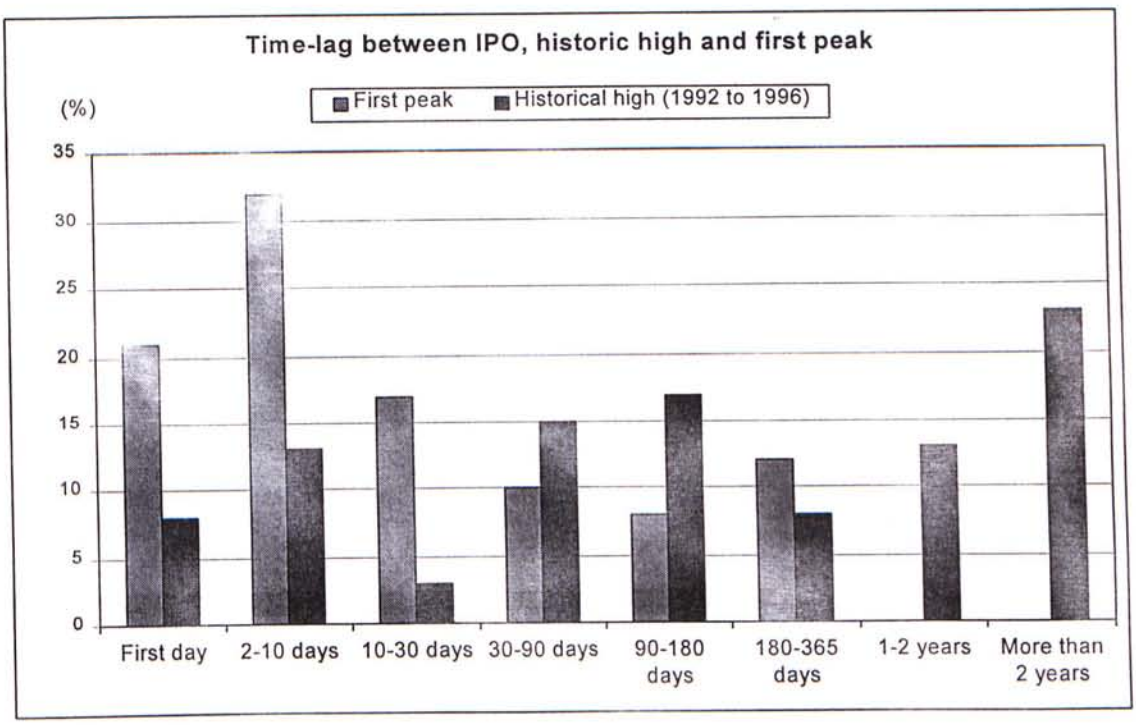
[11] Based on closing price on July 17, 1996

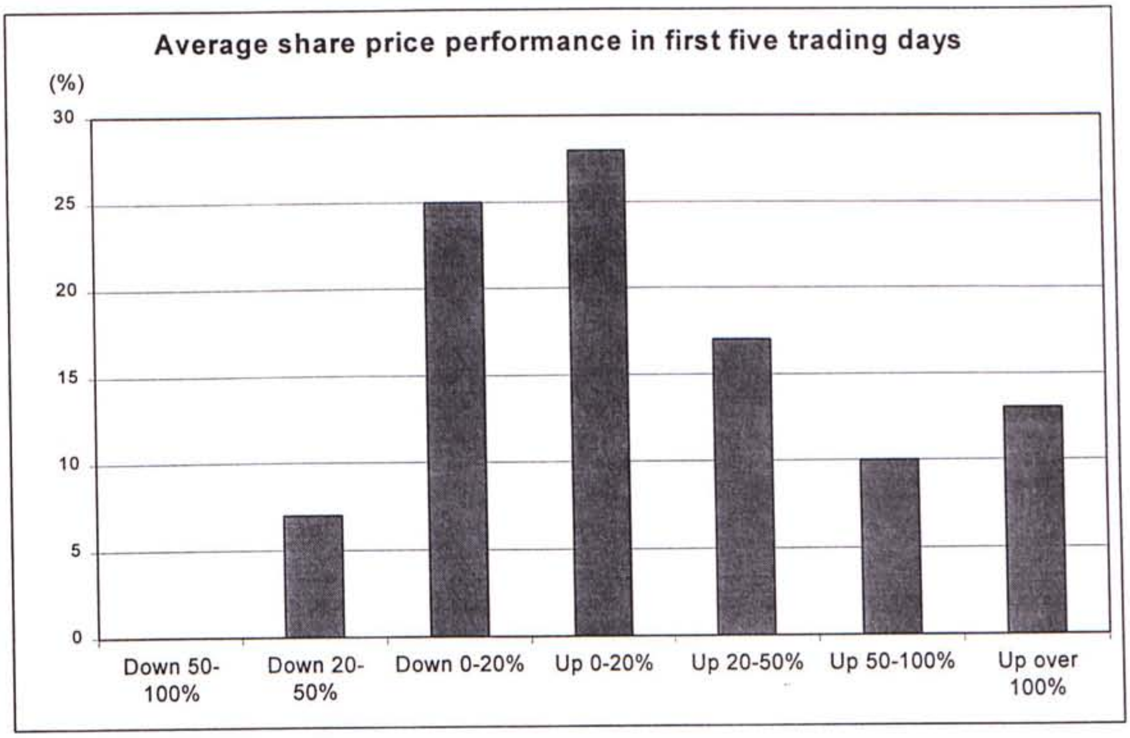
[12] Based on closing price on July 17, 1996

1. The short-term performance of CKI

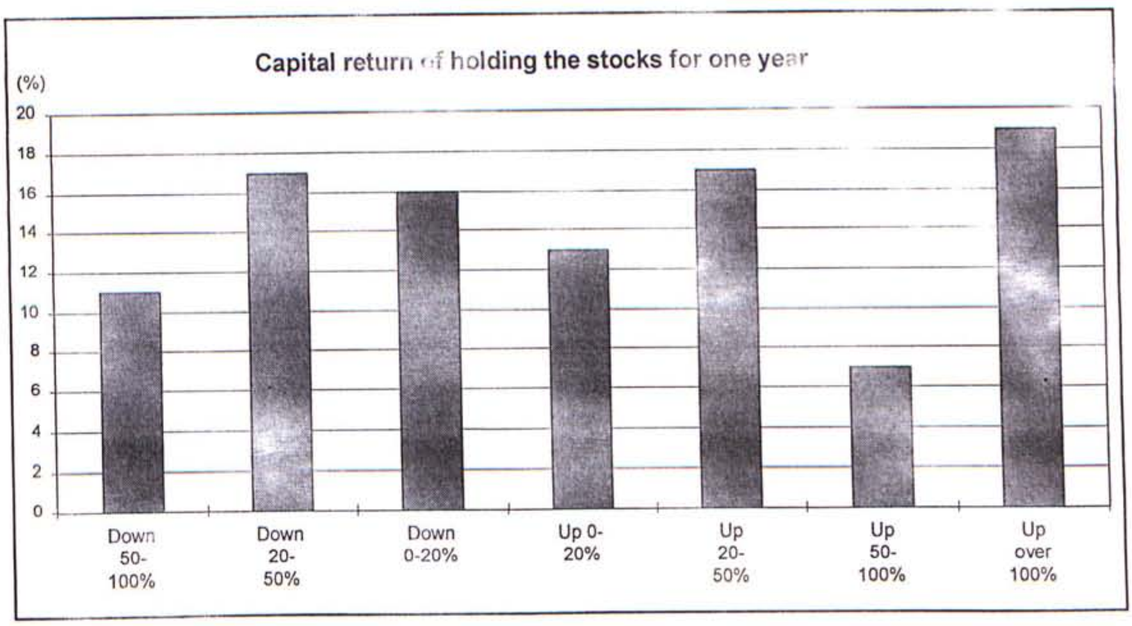
In order to shed some light on CKI's short-term performance after its debut, we have evaluated the share price performance of 47 China-related IPOs which were newly listed during January 1992 to December 1996. The raw data are summarised in Appendix VI. The following chart shows that nearly 70 per cent of these stocks reached their first significant share price peak 30 days or less after their IPO whereas CKI totally used 45 days to reach its first peak. Beside, CKI also needed 355 days to reach its historical high (calculation up to June 1997) whereas 56 per cent of these 47 new issues came to their respective historical high in less than 180 days. Although CKI had a relatively stable price appreciation in the meantime, short-term traders generally prefer stocks which can reach its historical high as early as possible, so that they can take profit and then switch to another issue.



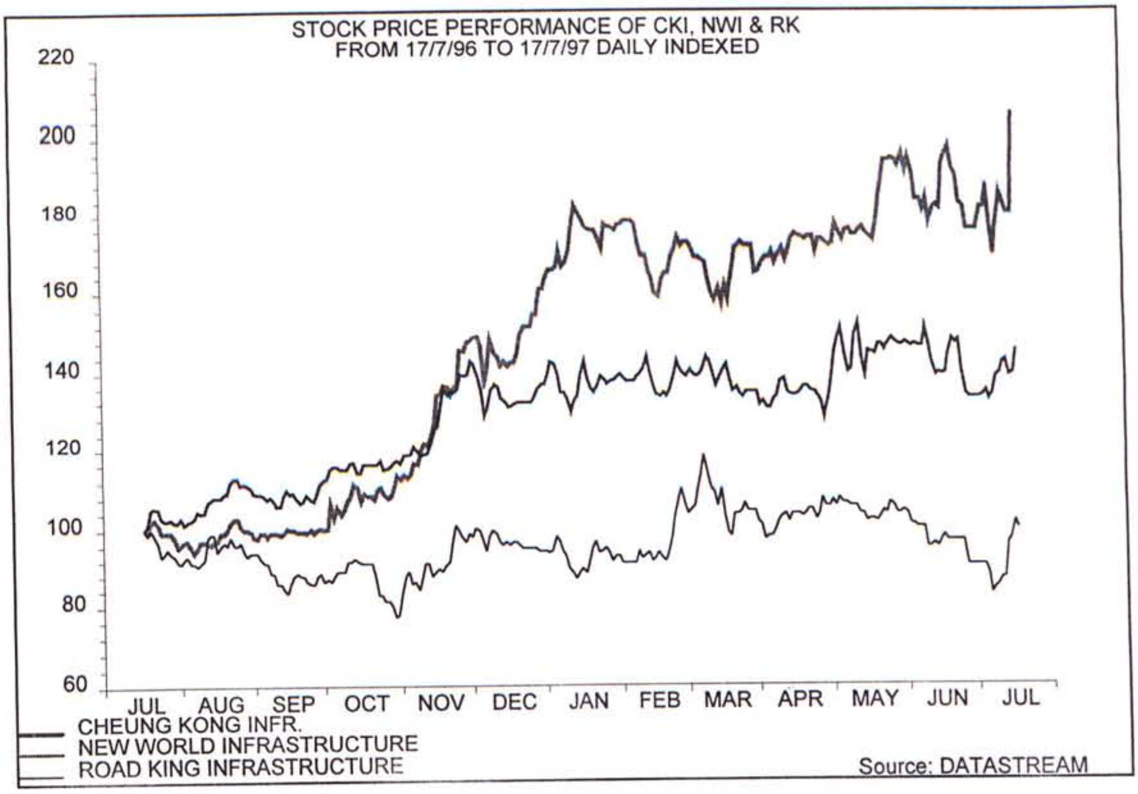
Next, nearly 67 per cent of these 47 selected shares traded higher than the IPO price in the first five trading days. However, CKI declined by 3.5 per cent within the same period. To sum up our observations, it is obvious that CKI had been underperforming shortly after its debut.



2. Long-term performance of CKI



While the short-term performance of CKI was not very good when compared with its peer group, its long-term performance was excellent. CKI accumulated appreciated by 107.1 per cent in one year's time, which is better than these 47 China-related IPO which only surged 18.3 per cent on average and with just 19 per cent of them could achieve a 100 per cent or above price gain.



In another test, the relative performance of CKI is compared with that of RKI and NWI. CKI was clearly outperformed another two PRC infrastructure stocks.

3. Reasons for the short-term underperforming of CKI

Among several factors, our group observes that the oversubscription rate is a variable that has a very close relationship with the share price performance immediately after the IPO. When our group plots 'the percent of share price accumulated appreciation in the first five trading days' as a dependent variable against 'the oversubscription rate' as the independent variable. The resulting regression line is:

Percentage of share price accumulated appreciation in the first five trading days
= -4 percent +0.2 per cent x oversubscription rate

The R^2 is 0.71, which is quite satisfactory. This is also consistent with the rationale that the rate of oversubscription demonstrates the demand for the scrip in the primary market. It this ratio is high, it means many investors are unable to obtain shares in the primary market, in which the only choice is to buy them in the secondary market.

As the oversubscription rate of CKH is 23.1 times, it should have a 0.62 per cent share price accumulated appreciation in the first five trading days according to the above equation, then why did the stock price declined by 3.5 per cent indeed. Our group believes another unfavourable factor is the general decline of the overall market during that period. Because of the rekindled worry on the US inflation rate, the Hang Seng Index had totally dropped by 2.3 per cent during these five trading days. This should be a psychological factor that affecting the share price performance of CKI.

CHAPTER XII

CONCLUSION

Looking backwards through time, the market capitalisation of CKI has grown from HK$17.9 billion in the debut on July 12, 1996 to its historical high of HK$63.5 billion on August 6, 1997. Furthermore, based on the existing market capitalisation of HK$50.5 billion, CKI is now the 13th largest listed company in Hong Kong. CKI has already became a new constituent stock of the benchmark Hang Seng Index one year after the initial listing and Mr Victor Li Tzar-Kuoi, aged 32 (son of tycoon Mr Li Ka-shing) has subsequently turned out to be the youngest CEO among the 33 constituent stocks. **Spin-off was the crucial step in this fast growing process of CKI. Being the major shareholders of the CKI, CKH also benefit from the whole deal.** As the degree of information asymmetry was relieved directly by the spin-off of CKI, CKH's share price started to outperform both the Hang Seng Property Subindex and the broadly based Hang Seng Index. Besides, our group also observes that there are some other managerial incentives for this deal. For instance, this spin-off reduced the CKI's future funding demand on CKH and it also provided an one-off extraordinary profit for CKH.

However, the IPO price of CKI seemed to be too demanding and CKI's share price subsequently underperformed the other newly listed red chips in that period . In fact, setting the initial offering price is not a easy task given so many unpredicable variables. Thus, both scholars and market practioners should pay more attention on this topic.

APPENDIX I

ANALYSIS OF SPIN-OFFS

When performing analysis on spin-off, it is important to look at the transactions between parent and spun-off unit that may affect future profitability or cash flow. Possible problem areas include:

1. The treatment of inter-company loan after spin-off e.g. loan capitalisation or repayment
2. Examine income tax sharing agreements, which detail the impact of additional tax assessments or refunds covering periods prior to the spin-off. Also consider that the spun-off unit inherits the tax basis as well as the accounting basis of assets and liabilities. If tax depreciation of fixed assets has exceeded depreciation expense, then future tax deductions will be below depreciation expense. Although the deferred tax liability in the balance sheet should provide for the reversal of this and other timing differences, there may still be a cash flow consequence if income taxes paid exceed future income tax expense.
3. How have post retirement benefits been dealt with? If the parent company retains responsibility for all benefits for retirees, for example, the spun-off will have a reduced burden. Also evaluate the allocation of pension plan assets and liabilities.
4. Contingent liability for debt or other obligations of the parent company.
5. Guarantees of spin-off obligations by the parent, but with the spun-off unit paying a fee for the guarantee.
6. Parent company charges for administrative or other services.
   a) Higher rental costs due to spun-off unit occupancy of parent company office space or operating facilities.
   b) Inter-companies supply agreements, which can be either positive or negative for the spun-off unit, depending on their terms. Such agreements often have provisions providing for termination or diminishment over time.

Spin-off gives a diversified company the opportunity to expand its own shareholder value by exposing a stellar subsidiary for a pure-play valuation by the public securities markets. After market movement depends on the operating performance of the spun-off unit and investor appetite for firms in specific industries. Although some investors immediately sell the shares of spin-offs they receive, others find spin-offs to be attractive investment opportunities. The following factors may make spin-offs profitable investments:

1. Operations that are "lost" in a large corporation may benefit from the focus of a management undistracted by other activities. Spun-off unit frequently provides stock options and other incentives for managers to improve profitability.
2. The smaller size of a spin-off may increase the flexibility of managers no longer bound by the bureaucracy of the former parent.
3. The spin-off may attract investors who wish to invest in its industry, but were deterred by the other operations of the former parent. The spin-off may also attract customers not previously accessible because they are competitors of the parent.
4. Even if the spun-off company has poor current profitability, investors may be attracted by high book value, cash flow, or other attributes.

In practice, a spin-off may increase shareholder wealth as the combined market value of the spin-off and parent company shares exceeds the pre-spin-off market value of the parent. Operations that contributed little or nothing to the parent company's market value (because of low profitability, or lack of visibility) may have substantial market value as a stand-alone company. The superior performance suggest that the company may have increased the value of its shares by "giving away" part of its operations.

APPENDIX II

BUSINESSES & HIGHLIGHTS OF CKI

1. Business profile

Incorporated in May 1996, CKI acquired from its parent company CKH its interests in the road and power businesses in China and GIC and AA in Hong Kong. After the reorganisation, CKI will invest in and manage power plants and toll roads and toll bridges and infrastructure-related businesses in the manufacture and sale of cement, the production and delivery of concrete, the production and laying of asphalt and the quarrying and selling of aggregates in Hong Kong and China.

2. Management team

The management of the Company is essentially the same as CKH, who are highly regarded for their vision and business skills. Mr. Victor Li, the elder son of Mr. Li Ka-shing, is the Chairman and Mr. Kam Hing-lam is the Managing Director. They are both Deputy Managing Director of CKH.

3. Major line of businesses

c) Power plants

CKI has interests in six power plants in the Guangdong province with an aggregate design capacity of 2,200 MW. The largest power plant is the Zhuhai power plant phase I, which is a 2x700 MW coal-fired electrical power plant. CKI has a 45 per cent interest in plant, which is expected to be completed by July 1999.

In Nanhai, CKI has interests in two power plants, namely Nanhai Jiangnam power plant and Nanhai power plant I. The former one is an existing 121 MW power plant, which came into operation between 1987 and 1992. CKI's joint-venture formally assumed operation and ownership of the power plant on January 1, 1995 and CKI is entitled to 10 per cent return on its investment. The latter one is a 400 MW (2x200 MW) oil-fired power plant currently under construction. The first generator is expected to be completed in December 1996, the second unit to be by February 1997. CKI is entitled to 20 per cent return on its investment. In Shantou, CKI has interests in three small-scale power plants with aggregate power generation capacity of 279 MW and is entitled to 10% return on its investment.

In general, these joint-venture contracts provide guarantees on minimum quantities of electricity off-take, which will thus safeguard return on investment by CKI.

d) Toll roads and bridges

CKI has interests in three roll roads and ten toll bridges in Shantou and Nanhai. The Shantou Bay bridge (SSB) and Shenzhen-Shantou Highway (Eastern Section) (SSHE) form a section of an eastern coastal corridor linking up Shenzhen and Shantou. The 11.33 km SSB is made up of a dual 3-lane bridges of 2.5 km in the south and a dual 2-lane approach road of 2.23 km in the south and a dual 2-lane approach road of 6.6 km in the north. The phase I of 5.93 km has been completed and became operational on June 30 1996, while phase II of the remaining section of the northern approach road is expected to be completed in the first half of 1997. Toll rates for phase I range from RMB10 to RMB110 for six vehicle categories.

SSHE is a 140 km dual 2-lane highway, which is expected to be completed and in operation by December 31 1996. Toll rate will range from RMB0.225 to RMB2.138 per km for five vehicle categories. Together with SSB and the western section, this highway will link up Shenzhen and Shantou and cut the traffic time from the existing eight hours to three and a half hours.

CKI has agreed to acquire interest in 11 roads in Nanhai Municipality. The first seven roads have been completed for US210m. CKI expects to acquire a 49 per cent interest for US$103m. The remaining four roads are expected to be completed by January 1999 for total project cost of US$120m. CKI will acquire a 64 per cent interest for US$77m.

e) Financing and distribution of profit

For joint-venture projects in China, the parties are generally required to contribute registered capital not less than one-third of its total investment. However, for the toll road projects, CKI and its partners are allowed to provide registered capital of only 10 per cent of its total investment, but the shortfalls are usually more than compensated for shareholders' loans. Fixed assets are usually depreciated over a minimum period of variable years without residual value and the depreciation charges are used to repay registered capital.

Revenue are firstly used for the payment of operating expenses, taxes, the three statutory funds and then to the repayment of principal of the shareholders loan and interest. After-tax net profits are distributed to the joint-venture parties in accordance with the ratio of their registered capital.

f) Cement and Concrete

Through its two principal subsidiaries, GI and AA, CKI plays a leading role in Hong Kong construction material market. It produces and sells cement, concrete, asphalt and aggregates. The former two products account for the majority of its sales and profit.

GI is the only integrated cement manufacturer in Hong Kong, supplying almost halt of the Hong Kong market. Its cement factory at Tap Shek Kok, Tuen Mun has a kiln capacity of approx. 2.5m tonnes per year. Ordinary portland cement accounts for about 70 per cent of its production with blended cement, making up the remaining 30 per cent.

AA operates 19 concrete batching plants, which have an annual concrete production capacity of approx. 4 m.c.m. In China, AA has interests in two batching plants located in Zhuhai and Guangzhou, which have production capacities of 300k c. m. and 400k c.m., respectively. AA operates two asphalt production plants in Lam Tei, Tuen Mun and Tai of 370k tonnes and 450k tonnes, respectively. AA has a quarry site at Lam Tei under a government contract, which can produce approx. 2m tonnes of aggregate per annum. The existing contract expires in June 1999, at which time AA plans to negotiate with the Hong Kong SAR Government for a new contract.

4. IPO key issue statistics

New issue	342.3m new share
Offer price	HK$12.65 per share
Issued shares	1,323.8m shares
Total net proceeds	HK$4.33 billion
Market capitalisation	HK$16.8 billion

5. IPO expected timetable

Application closes	12 noon, July 9,1996
Announcement of allotment	July 12, 1996
Refund cheques posted	July 15, 1996
Dealings commence	July 17, 1996

APPENDIX IV

LEGAL ASPECT OF SPIN-OFF

Recently, there have been an increasing number of spin-off proposals received by the Stock Exchange of Hong Kong Limited ("SEHK") from existing listed companies. In order to ensure that the market is safe and sound, the SEHK has issued a Practice Note to maintain the consistency of treatment of the spin-off proposals from existing listed issuers and to set out the SEHK's policy with regard to those proposals. The Practice Note takes effect from 12th May 1997 and with the following details:

1. No spun-off by the parent within 3 years of initial listing.
2. There should be clear commercial benefits in the spin-off both to the parent and the new spun-off unit.
3. There should be no adverse effect on the shareholders of the parent resulting from the spin-off.
4. There should be a clear separation between the business retained by the parent and the business of the new spun-off unit.
5. The remaining business of the parent would retain a sufficient level of operations and sufficient assets to support its own listing status.
6. The new spun-off unit should be able to function independently of the parent with regards to its business and operations, independence of directorship and management, independence of administrative capacity. The on-going and future connected transactions between the parent and the new spun-off unit would be properly transacted to safeguard the minorities' interests of both units.
7. The existing shareholders of the parent will be given the assured entitlement to share in the spun-off unit unless it is waived by the minority shareholders by resolution in general meeting.

8. The parent should circulate to its shareholders a circular providing full details of the spun-off and its effect on the parent, which would include the advice from independent financial advisers who may not be the sponsor or co-sponsor or an underwriter of the new spun-off unit. If there were a significant minority opposition, the independent financial advisors would need to submit a report to the SEHK as to the discussions at the relevant general meeting.

9. The latest time at which a formal announcement should be made is the time of lodgement of the Form A1 or its equivalent.

APPENDIX V

HISTORY OF CKH

Year	Events
1971	Incorporated in June under the name of 'Cheung Kong Real Estate Co. Ltd'
1972	Adopted its present name prior to offering 10.5m shares to the public in November
1977	Developed Elizabeth House and the Lockhart House
1979	Acquired 22.4 per cent of HWL and 25 per cent of Green Island Cement Ltd
1980	International City Holdings was formed as a joint venture with HWL
1993	Actively participated as minority interests in consortia led by the PRC interests. CKH also involved in infrastructure, comprising bridge, highway and power station projects as well as property development activity in Southern China. Teamed up with CITIC Pacific to make an unsuccessful take-over bid for listed Miramar Hotel & Inv. Co Ltd
1994	Issued US$350M exchangeable guaranteed floating rate notes, raising funds to finance the Group's property, hotel and infrastructure projects in China.
1996	CKI which holds the group's interests in infrastructure and infrastructure-related businesses in HK and China was separately listed in July. CKH retained 70.66 per cent interest in CKI after the listing.
1997	Underwent a group reorganisation, pursuant to which, CKH, 70.66 per cent interest in CKI was transferred to HWL, which transferred 35.01 per cent interest in HKE to CKI. As a result, HWL became the holding company of the group's infrastructure business.

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